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TAGS: EPET EINV ECON KZ
SUBJECT: KAZAKHSTAN: ALL SIDES SMILING WITH KASHAGAN DEAL

Classified By: Ambassador John Ordway, Reasons 1.4 (b) and (d)

SUMMARY

¶1. (C) In a marathon negotiating session on January 13, the Kashagan consortium partners reached agreement in principle with the Government of Kazakhstan (GOK) on restructuring the ownership and operatorship of the project, overcoming two main stumbling blocks. ENI had objected to a new operating model; ExxonMobil had rejected the price for the equity stake transferred to KazMunayGaz (KMG), Kazakstan's national oil and gas company. With the CEOs of all six foreign partners and Kazakhstani Prime Minister Masimov in the same room, ENI and ExxonMobil found themselves isolated and eventually joined the consensus. The parties agreed to an equity transfer to KMG that will result in KMG -- and thus the GOK -- having a Kashagan ownership share equal to that of the four largest consortium partners. They also agreed to a new operating model which will bring ExxonMobil, Shell and Total in as co-operators, each with a specific area of responsibility. KMG will share in overall management, and intends to ensure smooth and effective relations among the operating companies. End Summary.

¶2. (C) This cable is based on separate, extensive conversations after the agreement was reached with senior in-country management for ExxonMobil and ConocoPhillips, and with Maksat Idenov, KMG's first vice president.

OPERATORSHIP

¶3. (C) ENI has been the operator during the initial phase of Kashagan -- the world's largest oil discovery since Alaska's North Slope. By all accounts from companies within and outside the consortium, ENI does not have the capacity to operate a project of this complexity, which will entail extraction of sour oil under extremely high pressures using a complex and potentially dangerous gas reinjection scheme. The result has been repeated delays and massive cost overruns. The consortium partners we have been in regular contact with (ExxonMobil, ConocoPhillips and Shell) have been telling us privately since at least 2004 that ENI was in over its head. All the parties except ENI had long come to the conclusion that a new operating model was required.

¶4. (C) All of our interlocutors described ENI as being in denial until the very last moment of the negotiations about their inability to continue as Kashagan operator. KMG First Vice President Maksat Idenov told us that he had worked with ExxonMobil, ConocoPhillips and Shell to devise an approach

that would have the GOK, rather than the international companies, demand a change in the consortium's operating structure. In the course of the final nine-hour negotiating session, ENI CEO Paolo Scaroni, completely isolated and under attack particularly from ExxonMobil and Shell, finally gave in. The new arrangements, which will be worked out among the four majors involved within the next 4-6 weeks, envision dividing the operatorship into different aspects, including offshore, onshore, and drilling. The companies will reach the decision on who does what based on capabilities and availability of the appropriate expertise.

COMPENSATION/FINANCES

¶5. (C) In addition to the value transfer as a result of KMG's acquiring additional equity (para 6), the January 13 Kashagan deal also includes cash compensation to KMG. The most significant component is a $250,000,000 bonus payment to be made upon the commencement of production. ExxonMobil had tried to mitigate the value transfer by seeking a 10 year extension of the PSA, later reducing their demand to 5 years and then 3 years. The GOK stood firm, but did agree to give the current partners a right of first refusal on any extension or new PSA at its expiry. (Note: The size of the field and the delays in beginning production make it very likely that there will be substantial oil still in the ground when the current PSA expires. Given the reinjection of sour gas and high pressure in the fields, it is likely that even at that point the project will continue to be technically demanding and require the involvement of international majors. End Note.)

¶6. (C) Our intelocutors report that at no point during the negotiations did the GOK request the international partners to assume any responsibility for financing KMG's very large cash calls for capital expenditures and operating expenses over the next several years. Idenov told us that KMG plans to finance part of these cash calls through its own resources, and part by debt financing. He is planning a series of meetings with selected major European and Japanese banks over the next month or so to begin to line up commitments.

OWNERSHIP

¶7. (C) The GOK had signaled early on that it was seeking additional equity ownership to bring KMG's share in Kashagan up to the same level as the four large stakeholders -- ENI, Shell, Total and ExxonMobil -- and that it expected part of the compensation it felt it was due for delays and cost overruns to be reflected in the purchase price for KMG's additional stake. In the initial stages of the negotiation, it appeared that the GOK was preparing an all-out assault to get the consortium partners to agree to dilution of their shares. The GOK's arsenal included environmental charges, tax charges, labor violations, operating permits, the requirement for GOK approval of the operating budget and, most ominously, a new subsoil law that provided a potential legal basis to revoke the PSA. As serious negotiations got underway, however, all of these threats receded. (Note: The one exception was a threat by President Nazarbayev in a December meeting with Tillerson's deputy to use the subsoil legislation. Nazarbayev, however, reverted to his previous public line when he reassured the Ambassador privately the next day that the legislation would not/not be used against any existing contract. End Note.) In the end, both ExxonMobil and ConocoPhilips confirmed that the GOK used tough, but legitimate business pressures to pursue their case.

¶8. (C) ExxonMobil was the last holdout in agreeing to an increased ownership share for KMG. After Exxon signaled its willingness late last year to reduce its stake, the negotiations focused on the price for KMG's share. ExxonMobil, however, took a position of principle: it would

accept no less than "market price." ExxonMobil told us that CEO Rex Tillerson had decided that Exxon was going to hold the line on this issue. However, all our sources indidated that Tillerson was subjected to very strong pressure in the final negotiations, both by the other CEOs and by the Kazakhstani side. According to our in-country ExxonMobil contact (who was not in the meetings but who was extensively debriefed about them), it was the lure of future business in Kazakhstan that eventually led Tillerson to reverse course, and to agree to a "below market price" figure of $1.8 billion as the valuation of KMG's increased share. (Note: Determining the "market price" for this share is essentially impossible, as different financial models will yield wildly varying results depending on the assumptions used. That said, all parties involved agree that $1.8 billion is a "below market price," even if they can not tell you how much below market. End Note.)

¶9. (C) ExxonMobil has been pursuing a major and innovative on-shore proposal with the GOK for the past 18 months that would build on the company's acknowledged industry-leading skills and, if successful, produce major additional revenues for Kazakhstan. It was made explicit to ExxonMobil that failure to agree to the restructuring proposal would result in their losing any chance of additional business in Kazakhstan -- permanently. It apparently was the lure of this opportunity that persuaded ExxonMobil to accept what all the other majors had already agreed to. ExxonMobil told us that no promises were made about any future business, and the GOK is on the record publicly as saying that there were no side deals made. However, Idenov strongly hinted to us that an agreement with ExxonMobil was imminent -- and went out of his way to praise Exxon's professionalism, high standards, and critical role in the new operatorship arrangements for Kashagan. He claimed he had told Tillerson that ExxonMobil could have first pick on the aspect of the operatorship they wanted. The ExxonMobil office in Astana is scouring the town for new office space, and is anticipating the imminent arrival of more business development cadres.

COMMENT

¶10. (C) While KMG will benefit from some relatively modest guaranteed cash transfers, the real financial gain from the Kashagan deal for Kazakhstan is a greater share of upside potential if oil prices remain high -- though coupled with greater downside risk if prices drop or production does not materialize as projected. ExxonMobil evidently decided that the risk of being permanently shut out of development prospects in Kazakhstan was not worth the further argument on the market value of its existing Kashagan stake. For its part, ConocoPhillips is also bullish on its prospects in Kazakhstan over the next few years. They have offered to second technical experts to KMG, at no cost, to help them evaluate the N Block that Shell and ConocoPhillips had fought so hard over, and that KMG is now going to explore on its own. Idenov apparently has high regard for ConocoPhilips CEO Jim Mulva -- a fact that may further work to the benefit of the company. End Comment.
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